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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1938

No. 98

M. E. BLATT COMPANY, PETITIONER,

vs.

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

PETITION FOR CERTIORARI FILED JUNE 7, 1938.

CERTIORARI GRANTED OCTOBER 10, 1938.

SUPREME COURT OF THE UNITED STATES

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[fol. 1] **IN COURT OF CLAIMS**

No. 43592

M. E. BLATT COMPANY

v.

THE UNITED STATES

I. PETITION—Filed July 12, 1937

To the Chief Justice and Judges of the Court of Claims:

Petitioner and plaintiff, M. E. Blatt Company, respectfully represents:

1. The plaintiff is a corporation organized and existing under the laws of the State of New Jersey and has its office and principal place of business at Atlantic City, New Jersey.

2. In 1932, in conformity with the requirements of the Revenue Act of 1932, the plaintiff made and filed with the Collector of Internal Revenue at Camden, New Jersey, a consolidated return of income for the fiscal year ended January 31, 1932, for itself and an affiliated corporation, Mebco Realty Holding Company. The said return showed a tax due on the consolidated net income amounting to $1,294.25 which was duly paid by the plaintiff to the Collector of Internal Revenue.

3. Thereafter, upon the audit of the return in the Bureau of Internal Revenue, certain changes were made, including the addition of $1,742.31 to the net income of Mebco Realty Holding Company, upon the findings of an internal revenue [fol. 2] agent and for reasons hereinafter stated, infra. All the said changes resulted in a deficiency tax of $1,133.84, which included $209.08 on account of the addition of the said $1,742.31 to the net income of Mebco Realty Holding Company. The said deficiency tax of $1,133.84, with interest amounting to $160.41, was duly paid by the plaintiff to the Collector of Internal Revenue on September 5, 1934.

4. The findings on which was based the addition of $1,742.31 to the net income of Mebco Realty Holding Company were as follows:

In 1927 the plaintiff, through its affiliate Mebco Realty Holding Company, acquired by purchase a theatre, store and apartment building known as the City Square property on Atlantic Avenue, Atlantic City, New Jersey, adjacent to the plaintiff's place of business, title to the City Square property being taken in the name of Mebco Realty Holding Company. Thereafter and until some time in 1929 the said property was leased to the Stanley Company of America, which operated a theatre, and to other tenants who occupied the stores and apartments. All the said leases expired during the early part of 1929 and were not renewed.

September 13 and October 3, 1930, Mebco Realty Holding Company, as owner and lessor, entered into agreements with Ventnor Realty & Leasing Company, as lessee, and M. B. Markland Company, as contractor, which provided for the making of alterations and improvements, in accordance with certain plans and specifications, at cost to the lessor, Mebco Realty Holding Company, not to exceed $65,000.00, and for the leasing of the property to Ventnor Realty & Leasing Company for the operation of a first-class picture theatre [fol. 3] for a term of ten years beginning upon the day the improvements stipulated in the lease were completed and ending ten years from the commencement of the lease but in no event later than December 31, 1940.

Thereafter the said alterations and improvements were completed, together with other improvements requested and ordered by the parties in interest, the total cost of all such alterations and improvements being $114,468.77, of which $73,794.47 was paid by the lessor, Mebco Realty Holding Company, and $40,674.30 was paid by the lessee, Ventnor Realty & Leasing Company, as follows:

Paid by Mebco Realty Holding Company:		
Brick, steel, lumber, concrete, used in building	$45,068.73	
Heating and plumbing system	7,716.82	
Electrical work	8,699.84	
Ventilation system (partial)	3,514.61	
		$65,000.00
Building changes	661.86	
New store fronts (4)	8,132.61	
		8,794.47
		$73,794.47

Paid by Ventnor Realty & Leasing Company:		
Ventilating system (balance)	3,959.75	
Decorating, glazing, and architect's fees	11,313.14	
Chairs	9,167.24	
Booth	5,197.39	
Draperies	7,075.42	
Electric signs and marquee	3,961.36	
		40,674.30
		$114,468.77

[fol. 4] The said alterations and improvements were completed and the lessee went into possession under the terms of the lease, on or about February 1, 1931.

Thereafter, in the audit of the consolidated income tax return filed by the plaintiff and Mebco Realty Holding Company for the fiscal year ended January 31, 1932, it was determined by the internal revenue agent that the cost of the said improvements made by the lessee, to wit, $40,674.30, constituted taxable income to the lessor to the extent of the estimated salvage or depreciated value of such improvements at the end of the term of the lease, as follows:

	Total	Rate	Depreciated value at termination of lease
Ventilating system (balance), glazing, architect's fees, and other items	$14,326.12	3%	$10,028.29
Painting	760.80	10%	0
Other improvements	185.97	10%	0
Chairs	9,167.24	6-2/3%	3,055.75
Booth	5,197.39	10%	0
Draperies	7,075.42	6-2/3%	2,358.47
Electric signs and marquee	3,961.36	5%	1,980.63
	$40,674.30		$17,423.14

and that an aliquot part thereof, to wit, ten per cent or $1,742.31, should be added to the lessor's taxable income for each year of the lease. Revenue Act of 1932, sec. 22 (a); Regulations 77, Art. 63. Upon the basis of the said finding and determination the sum of $1,742.31 was added to the taxable income of Mebco Realty Holding Company for the fiscal year ended January 31, 1932, as stated in paragraph 3 supra.

[fol. 5] 5. The plaintiff avers that all the substantial improvements to the said property were those charged to the lessor, amounting to $73,794.47; as above set out; that the additional improvements which were charged to the lessee and for which the lessee paid $40,674.30, as above set out, including painting, decorating, glazing, installation of chairs, booths, draperies, and electric signs, and payment of architect's fees, were not improvements which added any substantial value to the property except for the purpose for which it was to be used by the lessee and so long as used by the lessee; that any value which the said improvements made by the lessee may have at the end of the term of ten years, or at any time to the lessor is uncertain and problematic and wholly impossible of ascertainment, by depreciation rates or otherwise, and at all events cannot be realized by the lessor until the sale or other disposition of the property; that no income, within the 16th Amendment to the Constitution of the United States, was realized by he plaintiff or by Mebco Realty Holding Company in the fiscal year ended January 31, 1932, by reason of the said improvements made by the lessee; and that the addition of $1,742.31 to the taxable income of Mebco Realty Holding Company for said fiscal year, for the reasons stated, was erroneous and improper.

6. Within two years after the payment of the deficiency tax assessed as stated in paragraph 3 supra, the plaintiff filed a claim for refund of $209.08, being so much of the deficiency tax as was based upon the addition of $1,742.31 to the taxable income of Mebco Realty Holding Company, as above stated. November 18, 1936, the said claim for refund was disallowed by the Commissioner of Internal Revenue.

[fol. 6] 7. No action or suit has been commenced or is pending in any court on account of the said claim, nor in Congress or in any of the executive department, except as stated above; no assignment or transfer of the whole or any part of the claim or of any interest therein has been made; the plaintiff has at all times borne true allegiance to the government of the United States and has not in any way voluntarily aided, abetted, or given encouragement to rebellion against the said government; and the plaintiff is justly entitled to the amount claimed, after allowing all just credits and set-offs.

Wherefore, the plaintiff prays judgment against the United States in the sum of Two Hundred Nine Dollars and Eight Cents ($209.08), with interest from 1932 as allowed by law.

M. E. Blatt Company, by M. E. Blatt, President.
Lawrence Cake, Attorney for Plaintiff.

Duly sworn to by M. E. Blatt. Jurat omitted in printing.

[fol. 7] II. General Traverse—Filed August 21, 1937

And now comes the Attorney General, on behalf of the United States, and answering the petition of the claimant herein, denies each and every allegation therein contained; and asks judgment that the petition be dismissed.

James W. Morris, Assistant Attorney General.

III. Argument and Submission of Case

On April 5, 1938, this case was argued and submitted on merits by Mr. Lawrence Cake, for plaintiff, and by Mr. Samuel E. Blackham, for defendant.

[fol. 8] IV. **Special Findings of Fact, Conclusion of Law and Opinion of the Court by Littleton, J.**—Filed May 31, 1938

Mr. Lawrence Cake for the plaintiff.

Mr. Samuel E. Blackham, with whom was Mr. Assistant Attorney General James W. Morris, for the defendant.

Mr. Robert N. Anderson and Mr. Fred K. Dyar were on the brief.

Plaintiff seeks to recover $211.61, additional income tax assessed and paid for its fiscal taxable year ending January 31, 1932, together with interest from September 5, 1934. This additional tax resulted from the inclusion in income of a lessor of real estate of an aliquot part of the depreciated cost or value of improvements made to such leased premises by the lessee.

The question presented is whether improvements made by a lessee, as required by the lease agreement, to the property which is the subject of the lease and which improvements become the property of the lessor, constitute income to the lessor at the time of completion of the improvements to the extent of the fair market value thereof.

Plaintiff contends that improvements made by the lessee cannot be held to constitute income to the lessor prior to sale or other disposition by him of the improvements made by the lessee or a sale of the property of which the improvements constitute a part.

[fol. 9] SPECIAL FINDINGS OF FACT

1. The plaintiff, a New Jersey corporation with office and principal place of business at Atlantic City, made and filed a consolidated return of income for the taxable year ended January 31, 1932, for itself and a subsidiary corporation, Mebco Realty Holding Company, all the stock of which was owned by the plaintiff. This return showed a tax of $3,920.10, which was paid by the plaintiff.

2. Thereafter, upon the audit of the return, certain changes were made including the addition of $1,742.31 to the reported income of Mebco Realty Holding Company on account of certain improvements made to property owned by Mebco Realty Holding Company by the lessee of the property, which improvements were held by the Commissioner of Internal Revenue to constitute income to the lessor to the extent of the estimated depreciated value thereof at the termination of the lease. All the changes in the plaintiff's return resulted in a deficiency tax of $1,133.84, which was assessed against the plaintiff, and which, with interest amounting to $160.41, was paid by the plaintiff September 5, 1934.

3. The addition of $1,742.31 to the reported income of Mebco Realty Holding Company, as stated in finding 2, was based upon the following facts:

In 1927 Mebco Realty Holding Company (hereinafter referred to as the Realty Company) acquired by purchase certain improved real estate in Atlantic City, New Jersey, described as No. 1318 Atlantic Avenue.

September 13, 1930, the Realty Holding Co. leased this property to Ventnor Realty & Leasing Company, a New

Jersey corporation (hereinafter referred to as the Ventnor Company) for use as a moving picture theater, for a term of ten years, beginning upon the day certain improvements were completed by the landlord and ending ten years from the commencement of the lease but in no event later than December 31, 1940. With respect to the contemplated improvements to the property the lease provided:

5. It is further agreed by and between the parties hereto that the landlord will, at its own cost and expense, make [fol. 10] and complete alterations to the entrance and theatre, which is to accommodate as many seats as possible, and include plastering but no decorating, in accordance with the plans and specifications to be prepared by an architect to be selected by the parties hereto. It is further agreed that the tenant will paint and decorate, provided the landlord contributes a sum not exceeding Fifteen Hundred Dollars ($1,500) for such purpose to tenant. Tenant agrees to install the latest type of moving picture and talking apparatus, theatre seats, and all other fixtures, furniture, and equipment necessary for the successful operation of a modern up-to-date theatre, which shall at the expiration or other sooner determination of this lease become the property of the landlord.

October 3, 1930, the Realty Co., as owner, entered into a contract with M. B. Markland Company, as contractor, for the making of alterations and improvements as contemplated by the parties to the lease, in accordance with plans prepared by an architect employed by the parties upon the following terms and conditions, among others: that the owner (Mebco Realty Holding Company) would pay the actual cost of the alterations and improvements agreed upon by the parties and in accordance with the architect's plans, plus a contractor's profit of 10 per cent, provided that the total cost, including contractor's profit and architect's fee, would not exceed $65,000; and that "such additional work and materials as may be ordered by the Ventnor Realty & Leasing Company shall be paid for by said Ventnor Realty & Leasing Company." At the same time the Ventnor Company executed an agreement consenting to all the terms of the foregoing contract, as being made pursuant to the terms of the lease, and agreeing to pay for such work and labor in addition to work and labor covered by the contract, as it (the Ventnor Company), might order.

All the alterations and improvements were completed in January 1931, and the Ventnor Company, as lessee, took possession of the property February 1, 1931.

The total cost of all the alterations and improvements was $114,468.77 which was charged to the lessor and lessee, respectively, and paid for by them, as follows:

[fol. 11] Paid by the Realty Company, lessor:

Brick, steel, lumber, concrete	$45,068.73	
Heating and plumbing system	7,716.82	
Electrical work	8,699.84	
Ventilation system (partial)	3,514.61	
		$65,000.00
Building changes	661.86	
New store fronts (4)	8,132.61	
		8,794.47
		$73,794.47

Paid by the Ventnor Company, lessee:

Ventilating system (balance)	3,959.75	
Decorating, glazing, and architect's fee	11,313.14	
Chairs	9,167.24	
Booth	5,197.39	
Draperies	7,075.42	
Electric signs and marquee	3,961.36	
		40,674.30
		$114,468.77

The estimated depreciated value at the termination of the lease of the alterations and improvements paid for by the lessee was computed by the Commissioner and was agreed to by the plaintiff, as follows:

	Cost	Depreciated value at end of 10 years
Ventilating system	$3,959.75	$2,771.83
Glazing, architect's fee, and other items	10,366.37	7,256.46
Painting	760.80	0
Other improvements	185.97	0
Chairs	9,167.24	3,055.75
Booth	5,197.39	0
Draperies	7,075.42	2,358.47
Electric signs and marquee	3,961.36	1,980.69
	$40,674.30	$17,423.14

4. The additional tax paid by the plaintiff for 1932 as the result of the addition of $1,742.31 to the income of the Realty Company amounted to $211.61.

5. Thereafter plaintiff filed a timely claim for refund on the ground that the addition of $1,742.31 to the reported income of the Realty Company, as reflected in the plaintiff's [fol. 12] consolidated return for 1932, was incorrect. The claim was disallowed February 5, 1937.

Conclusion of Law

Upon the foregoing special findings of fact, which are made a part of the judgment herein, the court decides, as a conclusion of law, that plaintiff is not entitled to recover, and its petition is dismissed.

Judgment is rendered against plaintiff for the cost of printing the record herein, the amount thereof to be entered by the clerk and collected by him according to law.

Opinion

Littleton, Judge, delivered the opinion of the court:

Plaintiff relies upon the decision of the Circuit Court of Appeals, 2nd Circuit, in Hewitt Realty Company v. Commissioner, 76 Fed. (2d) 880, in which the court held in substance that no taxable income is derived by a lessor from improvements made to leased buildings or from buildings constructed upon leased land by the lessee until such improvements are sold or disposed of by the lessor. In support of this holding, plaintiff insists that there can be no income, in a constitutional sense, unless there is a realization by the taxpayer either by severance from the source, as in the case of rent derived from property, or by conversion of both source and income into a different form, as in the case of a gain derived from the sale or exchange of property, and that mere appreciation in value, in whatever form arising, is not income until realized by sale or conversion of the property.

Since the adoption of the 16th Amendment, Congress has generally defined taxable gross income (section 22, Revenue Act of 1932) as including gains, profits, and income derived from dealings in property, whether real or personal, growing out of the ownership or use of, or interest in such property; also from rent or other gains or profits and income derived from any source whatever. The net income to be taxed is this gross income less the allowable deductions. It is clear that Congress intended in all of the revenue acts, except

[fol. 13] when otherwise specifically provided, to reach gains and profits of every description. Irwin v. Gavitt, 268 U. S. 162. And constitutional requirements as to the receipt of income are satisfied if the taxpayer has become the owner of property the value of which represents the gain. Poe v. Seaborn, 282 U. S. 101. Improvements to leased property made by a lessee, which become the property of the lessor at the time made, constitute compensation paid by the lessee as additional rental for the use of the leased premises. This compensation is a fixed, definite, and ascertainable amount under the contract. The cost of improvements less depreciation over the term of the lease is a fair measure of their present worth to the lessor as rental for the leased premises in addition to the stipulated money payments to be made by the lessee, and this amount may, we think, be properly regarded as a gain, profit, or income to the lessor under the Sixteenth Amendment and the statutory definition of taxable income. Such amount is not an indefinite element similar to natural appreciation in market value of property owned by a taxpayer or appreciation in value through capital improvements made by the owner of the property which need some form of measurement, such as a sale, to be rendered definitely known and ascertainable in amount. A lessor has the unrestricted ownership of the leased premises, although, as a result of the lease, he is deprived of the beneficial use of the leased premises and, therefore, of the beneficial use of the gains accruing to him through improvements constructed by the lessee, but we think it is clear that under the statute the gain, profit, or income is not divested of its character, as such, by the lease arrangement which may limit, for a time, its use or disposal by the taxpayer or which may entirely deprive the lessor for the period stated in the lease of the beneficial use of the gain. Lucas v. Earl, 281 U. S. 111; Lonsdale v. Commissioner, 32 Fed. (2d) 537; Cleveland Railway Company v. Commissioner, 36 Fed. (2d) 347; Standard Slag Company v. Commissioner, 63 Fed. (2d) 820; Commissioner v. Terre Haute Electric Co., Inc., 67 Fed. (2d) 697. The lessor is free to sell or otherwise dispose of the improvements subject to the lease. These views on the question presented are sup-
[fol. 14] ported by the weight of authority upon the subject. Miller v. Gearin, 258 Fed. 225; United States v. Boston & Providence R. R. Corporation, 37 Fed. (2d) 670;

Crane v. Commissioner, 68 Fed. (2d) 640; Slack and Merwin, Exrs., v. Commissioner, 35 B. T. A. 271; Morphy v. Commissioner, 35 B. T. A. 289. The case of Hewitt Realty Co. v. Commissioner, supra, is distinguishable upon the facts. In that case the original term of the lease was for a period of 21 years and the improvements (a new building) constructed in 1931 by the lessee upon the leased premises had a useful life of 40 years. The Commissioner used the original 21-year term of the lease in computing the lessor's gain. But the lease contained a provision reserving to the lessee the right at the end of 21 years to renew the lease for three successive-running terms, or for a period of 63 years beyond the original term of 21 years. On this point the court held, and with this holding we agree, that effect should be given to the right of the lessee to continue the lease for a term beyond the useful life of the improvements. There was, therefore, no present increase in the net worth to the lessor and no existing or ascertainable gain to the taxpayer under the interpretations of the statute as set forth in Treasury regulations and decisions. In such a case a taxpayer, lessor, derives no profit or income unless the lease is terminated or until he sells the improvements.

Whether the gain or income to the lessor, through improvements made to the leased premises by the lessee, should be treated as taxable to the lessor in the year in which the improvements are completed or allocated and taxed annually over the term of the lease, or be treated as taxable in the year of expiration or termination of the lease, is a matter about which there might well be a difference of opinion. The regulations and decisions of the department charged with the administration and enforcement of the revenue laws should be sustained, unless they are contrary to the statute or exceed the authority conferred to make all needful rules and regulations for the necessary and proper enforcement of the provisions of the Revenue Acts.

Art. 63, Treasury Regs. 77, promulgated under the Revenue Act of 1932, provides, so far as material here, as follows:

[fol. 15] Improvements by lessees.—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the

lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

Except in cases where the lessor has exercised the option to report income upon basis (b), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor derives no income by reason thereof, and, just as when the lessor comes into possession or control of the property upon the expiration of the lease, the basis for determining gain or loss to the lessor from the subsequent sale or other disposition of the buildings or improvements and for depreciation in respect of such property is the amount previously reported as income by the lessor because of the erection of the buildings or improvements, except that if the buildings or improvements were acquired prior to March 1, 1913, the basis shall be their value subject to the lease when acquired or their value subject to the lease on March 1, 1913, whichever is greater. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. If the buildings or improvements destroyed were acquired prior to March 1, 1913, the deduction shall be based on their value subject to the lease when acquired or their value subject to the lease on March 1, 1913, whichever is greater, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. (See articles 130 and 204.)

[fol. 16] In all cases where the lessor has exercised the option to report income upon basis (b), if the lease is terminated so that the lessor comes into possession or control of

the property prior to the time originally fixed for the expiration of the lease, the lessor derives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise.

This regulation substantially conforms to all regulations and decisions of the Treasury Department since the adoption and promulgation in 1920 of Art. 48, Regs. 45, under the Revenue Act of 1918. Thus, for more than eighteen years, income derived by a lessor through improvements made to the leased premises by the lessee have been treated as taxable to the lessor to the extent of the present value thereof, either in the year in which the improvements were completed or proportionately in each year over the term of the lease. Since the adoption and promulgation of this regulation, which was applied and followed by the Commissioner of Internal Revenue in determining the income and the tax involved in this proceeding, the Congress has enacted seven general revenue statutes without in any way disturbing the regulations and decisions of the Treasury Department on this question. From this it seems clear that the Congress has given its approval to the interpretation of the statutes by the administrative branch of the Government charged with their administration and enforcement. National Lead Co. v. United States, 52 U. S. 140; Duffy v. Central Railroad Co. of New Jersey, 268 U. S. 55, 57; Brewster v. Gage, 280 U. S. 327, 337; United States v. [fol. 17] Farrar, 281 U. S. 624; Universal Battery Co. v. United States, 281 U. S. 580; Poe v. Seaborn, supra; McCaughn v. Hershey Chocolate Co., 283 U. S. 488, 492; Old Colony Railroad Co. v. Commissioner, 284 U. S. 552, 557; Massachusetts Mutual Life Insurance Co. v. United States, 288 U. S. 269; Old Mission Portland Cement Co. v. Helver-

ing, 293 U. S. 289; Hartley v. Commissioner, 295 U. S. 216, 220; and Williams v. Burnet, 59 Fed. (2d) 357.

Plaintiff is not entitled to recover and the petition is dismissed. It is so ordered.

Whaley, Judge; Williams, Judge; Green, Judge; and Booth, Chief Justice, concur.

[fol. 18] V. JUDGMENT

At a Court of Claims held at the City of Washington on the 31st day of May, A. D., 1938, judgment was ordered to be entered as follows:

Upon the special findings of fact, which are made a part of the judgment herein, the court decides, as a conclusion of law, that plaintiff is not entitled to recover.

It is Therefore Adjudged and Ordered that the plaintiff's petition be and the same is hereby dismissed.

[fol. 19] Clerk's certificate to foregoing transcript omitted in printing.

Endorsed on cover: File No. 42583. Court of Claims. Term No. 98. M. E. Blatt Company, petitioner, vs. The United States. Petition for a writ of certiorari and exhibit thereto. Filed June 7, 1938. Term No. 98, O. T., 1938.

[fol. 20] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed October 10, 1938

The petition herein for a writ of certiorari to the Court of Claims is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.